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APPORTIONMENT BETWEEN LIFE TENANT AND REMAINDERMAN OF LOSS ON DEFAULTED MORTGAGE SECURITY HELD IN TRUST

By CHARLES V SHIPLEY*

I. THE APPORTIONMENT RATIO

In cases in which mortgages on real estate are legal trust investments[1] and the trustee of a trust, in which one person is entitled to the trust income and another to the corpus on the happening of a designated event, forecloses a mortgage held as a trust investment and realizes on the security at a loss to the trust estate,[2] the question of apportionment arises.[3] The intention of the settlor if expressed in the trust instrument, or reasonably ascertainable from the circumstances surrounding its execution, will control.[4] In the absence of any direction by the settlor a rule based upon some legal theory must be applied.[5]

The courts have laid down various rules of apportionment which, for convenience of discussion, will be designated as

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[1] See 2 SCOTT, TRUSTS (1939) Sec. 227.7; Bailey and Rice, *The Duties of a Trustee with Respect to Defaulted Mortgage Investments* (1935, 1936) 84 U. of Pa. L. Rev. 157, 327, 625, at p. 157, note 1.

[2] This paper does not deal with the situation where the realization of a mortgage security results in a profit. For discussion of this situation *see* Bailey and Rice, *op. cit. supra* note 1, at 167.

[3] " the loss should be equitably apportioned between the innocent life tenant and the remainderman." In re Tuttle, 49 N. J. Eq. (4 Dick.) 259, 24 Atl. 1, 2 (1892). "The equity of the life tenant to receive the whole income during his tenancy is every whit as great as that of the remainderman to have the corpus of the trust remain unimpaired." In re Otis Will, 276 N. Y. 101, 11 N. E. (2d) 556, 558 (1937). "Mr. Justice Cullen says, 'Why should the life tenant fast for twenty-five years, that the remainderman may feast at the end of that period? Why should each not have exactly his own so far as it is possible to ascertain it?' " In re Marshall, 43 Misc. 238, 88 N. Y. Supp. 550, 552 (Sur. Ct. 1904) [quoting from Matter of Rogers, 22 App. Div. 436, 48 N. Y. Supp. 173, 181 (Sup Ct., App. Div. 1897)]. "It is well settled that where the interest upon mortgages is unpaid, and the premises are eventually sold, the sum received should be ratably apportioned between principal and income." Meldon v. Delvin, 31 App. Div. 146, 53 N. Y. Supp. 172, 180 (1898), affd. 167 N. Y. 573, 60 N. E. 1116 (1901). The situation here is to be distinguished from that involving unproductive real estate. *See infra* note 35.

[4] Matter of Chapal's Will, 269 N. Y. 464, 199 N. E. 762, 103 A. L. R. 1268 (1936), 4 BOGERT: TRUSTS AND TRUSTEES (1935) Sec. 820; 2 SCOTT, *op. cit. supra* note 1, Sec. 227.7.

[5] Note (1936) 49 Harv. L. Rev. 805.

follows New York Rule The life tenant and the remainderman share in the net proceeds, respectively, in the ratios of the arrears of interest at the date of final realization and the unpaid principal to the total of the unpaid interest and unpaid principal.[6]

Restatement Rule The remainderman takes that part of the net proceeds which, if invested at the time of default, would, with interest at the prevailing rate of earnings upon trust investments, equal the net proceeds at the time of realization. The difference between the net proceeds and the principal thus determined goes to the life tenant.[7]

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[6] The rule is applied or recognized in one of its various forms in Hudson County National Bank v. Woodruff, 122 N. J. Eq. 441, 194 Atl. 266 (1937), Equitable Trust Co. v. Swoboda, 113 N. J. Eq. 399, 167 Atl. 525 (1933), Trenton Trust and Safe Deposit Co. v Donnelly, 65 N. J. Eq. 119, 55 Atl. 92 (1903), In re Tuttle, 49 N. J. Eq. (4 Dick.) 259, 24 Atl. 1 (1892), Hagan v. Platt, 48 N. J. Eq. 206, 21 Atl. 860 (1891), In re Wilson's Estate, 167 Misc. 754, 4 N. Y. Supp. (2d) 634 (Sur. Ct. 1938), In re Otis Estate, 158 Misc. 804, 287 N. Y. Supp. 758 (Sur. Ct. 1936), Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937), Re Martin, 165 Misc., 597, 1 N. Y. Supp. (2d) 80 (Sur. Ct. 1937) Re Manger, 165 Misc. 254, 300 N. Y. Supp. 878 (Sur. Ct. 1937) In re Phelps's Estate, 162 Misc. 703, 295 N. Y. Supp. 840 (Sur. Ct. 1937), In re Chapal's Estate, 161 Misc. 67, 292 N. Y. Supp. 663 (Sur. Ct. 1934) In re Chapal's Will, 280 N. Y. Supp. 811, 245 App. Div. 818 (Sup. Ct. 2d Dept. 1935) Matter of Chapal's Will, 260 N. Y. 464, 199 N. E. 762 (1936) (Reversing In re Chapal's Will and modifying In re Chapal's Estate), In re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723 (Sur. Ct. 1936) In re Jackson's Will, 135 Misc. 329, 239 N. Y. Supp. 362 (Sur. Ct. 1929) *affirmed,* In re Jackson's Will, 232 App. Div 425, 250 N. Y. Supp. 324 (Sup. Ct., 2d Dept. 1931), *reversed on other grounds;* In re Jackson's Will, 258 N. Y. 281, 189 N. E. 496 (1932), *rehearing denied;* In re Brooklyn Trust Co., 258 N. Y. 610, 180 N. E. 354 (1932), In re Myers' Estate, 161 N. Y. Supp. 1111 (Sur. Ct. 1916), In re Marshall, 43 Misc. 238, 88 N. Y. Supp. 550 (Sur. Ct. 1904), Meldon v. Delvin, 31 App. Div. 146, 53 N. Y. Supp. 172 (Sup. Ct. 1st Dept. 1898) Wallace v. Wallace, 90 S. C. 61, 72 S. E. 553 (1911); Re Horn's Estate, 2 Ch. 222 (1924) Re Southwell, 85 L. J. 70 (Ch. 1915), 1 Ch. 942; In re Moore, 54 L. J. 432 (Ch. 1885), Stewart v Kingsdale, 1 Ir. R. 496 (1902).

[7] In re Nirdlinger's Estate, 327 Pa. 171, 193 Atl. 30 (1937), Re Nirdlinger, 331 Pa. 135, 200 Atl. 656 (1938) Roosevelt v. Roosevelt, 5 Redf. 264 (N. Y. Surr. 1881) (adopting 5% as a rate of interest) In re Golden (1893) 1 Ch. 292 (no reason given for the adoption of 4% interest)

The Uniform Principal and Income Act, 9 Uniform Laws Ann. (1940 Supp.) 278, 281, Sec. 11, lays down the following rule: "(2) Such income shall be the difference between the net proceeds received from the property and the amount which, had it been placed at simple interest at the rate of five per centum per annum for the period during which the change was delayed would have produced the net proceeds at the time of change, but in no event shall such income be more than the amount by which the net proceeds exceeds

Canadian Rule. Such interest payments as have been received by the life tenant are added to the net proceeds. The life tenant shares in the total thus obtained in the ratio established by dividing the total the life tenant would have received, had there been no default, by the sum of what both life tenant and the remainderman would have received had there been no default. After the life tenant has accounted for that which he has already received, by way of interest payments, the residue of the net proceeds goes to the remainderman.[8]

Proposed Rule (1) Such interest payments as have been received by the life tenant are added to the net proceeds. The life tenant shares in the total thus obtained in the following ratio take the present value of an annuity of the amount of the annual interest payment at the mortgage rate of interest (for the period which elapsed from the acquisition of the mortgage by the trust estate to the maturity of the mortgage, or the foreclosure sale, whichever period is the shorter), divide this by the sum representing the present value of the annuity plus the present value of the principal of the mortgage (figured at the mortgage rate of interest and due in a like number of years) The life tenant

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the fair inventory value of the property or in default thereof its market value at the time the principal was established or its cost where purchased later." It is to be noted (1) that the rate of interest is fixed and arbitrary and (2) that income cannot be more than the excess of the net proceeds over the fair market value of the investment at the time the principal was established, et cetera. It seems that under this rule the life tenant could take none of the net proceeds until the principal is fully repaid. RESTATEMENT, TRUSTS: Sec. 241, com. (c), Ill. (4)

[8] Re Foster, 45 Ch. Div. 629 (1890) followed by In re Plumb, 29 Ont. Rep. 601, 602 (1896). There must be taken: "1. An account of the amount which would be required to pay off the said security in full, including both principal and interest, and any other charges against the same.

"2. An account of what proportion of the said money in the preceding paragraph mentioned, if any had been paid, would have been payable to the (life tenant) and the amount which would have belonged to the principal of the trust fund.

"3. An account of the interest upon the said security, if any, which had already been paid to (the life tenant) After taking the said accounts, the amount realized from the security, and the amount already paid to the (life tenant) are to be added together, and the said amount is to be divided between (the life tenant) and the estate in proportion to the amount that they would have been entitled to if the whole of the said security had been paid in full, and the (life tenant) is to stand charged as to her portion thereof with the amounts already paid to her."

must account for interest payments he has received. The remainder of the net proceeds goes to the remainderman. (2) If, while the trustee holds the property obtained on foreclosure and sale, a duty to sell arises, the Restatement Rule applies to that portion of the property that was equitably owned by the remainderman.

The New York Rule is based on the principle that

"In such an investment situation what is involved is the salvage of a security The security is security not for principal alone but for income as well. On a sale, therefore, the (net) proceeds should be apportioned between principal and income in the proportion fixed by the respective amounts thereof represented by the net sale proceeds."[9]

At the time the security is realized there are two charges upon it—arrears of interest and also unpaid principal.[10] Beyond this simple principle the cases present "a hopeless maze of contradictory rulings."[11] The main difficulty has been the question whether "accrued interest" should include interest only to the date of foreclosure, or rather until final disposition of the property, and if the latter, then what rate of interest should be allowed. In *Re Will of Otis*[12] the court said that the fair thing would be to allow the life tenant the mortgage rate on the appraisal value of the property for each year, but since such course is impractical, the life tenant should be allowed interest at the mortgage rate until liquidation, for "if the remaindermen are to participate in the apportionment on the feigned basis of unimpaired principal, the share of the life tenant should be computed on the same assumption."[13]

[9] The court continued: "In the capital account will be the original mortgage investment. In the income account will be unpaid interest accrued to the date of sale upon the original capital. The ratio established by these respective totals determines the respective interest in the net proceeds of a sale." The term "ratio" as here used is somewhat confusing, since ratio implies a direct fractional relationship. Both capital and income could not "share" in the net proceeds in one ratio unless they each contribute to the same amount. Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937). See Bailey and Rice, *op. cit. supra* note 1, at 173.

[10] Re Atkinson, (1904) 2 Ch. 160.

[11] In re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723, 744 (Sur. Ct. 1936).

[12] 276 N. Y. 101, 11 N. E. (2d) 556 (1937).

[13] *Id.*, 11 N. E. (2d) at 557.

The decisions present conflicting holdings on:

Rate of interest. That no interest should be allowed after foreclosure; in re Jackson's Will, 135 Misc. 329, 239 N. Y. Supp. 362 (Sur.

The restatement rule is adopted, apparently, on the supposed analogy of the foreclosure situation to the case where unproductive land is held by a trustee,[14] and seemingly does not attempt to differentiate the two. It is said. "The allowance of interest at current rate from the time of default until the time of sale recognizes the real situation (viz.)[15] what rate of interest the trustee could obtain on the investment if the capital sum were really in hand."[16] This rule ignores the fact

Ct. 1929), *affirmed,* In re Jackson's Will, 232 App. Div. 425, 250 N. Y. Supp. 324 (Sup. Ct. 2d Dept. 1931), *reversed on other grounds.* In re Jackson's Will, 258 N. Y. 281, 179 N. E. 496 (1932), *rehearing denied,* In re Brooklyn Trust Co., 258 N. Y. 610, 180 N. E. 354 (1932), Furniss v. Cruikshank, 191 App. Div. 450, 181 N. Y. Supp. 522 (Sup. Ct. 1st Dept. 1920) (the life tenant evidently did not ask for an apportionment and it does not appear affirmatively that any apportionment whatsoever was made).

That the mortgage rate should be allowed until the acquisition of the property by the trust estate and the prevailing rate on trust investments thereafter until final liquidation; Re Manger, 165 Misc. 254, 300 N. Y. Supp. 878 (Sur. Ct. 1937), In re Phelp's Estate, 162 Misc. 703, 258 N. Y. Supp. 840 (Sur. Ct. 1937; In re Otis Estate, 158 Misc. 804, 287 N. Y. Supp 758 (Sur. Ct. 1936), *overruled* in Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (Sur. Ct. 1937), In matter of Marshall, 43 Misc. 238, 88 N. Y. Supp. 550 (Sur. Ct. 1904), Meldon v. Delvin, 31 App. Div. 146, 53 N. Y. Supp. 172 (Sup. Ct., 1st Dept. 1898).

The date of the beginning of the apportionment period is under all the cases except Re Phillimore (1903) 2 Ch. 942, at the first default in interest. In that case it was set at the time the mortgage first appeared insecure.

Generally, capital is the original mortgage investment; Trenton Trust and Safe Deposit Co. v. Donnelly, 67 N. J. Eq. 119, 55 Atl. 192 (1903), Hagan v. Pratt, 48 N. J. Eq. 206, 21 Atl. 860 (1891), Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (Sup. Ct. 1st Dept. 1937), Meldon v. Devlin, 31 App. Div. 146, 53 N. Y. Supp. 172 (1898), Wallace v. Wallace, 90 S. C. 61, 72 S. E. 553 (1911), In re Moore, 54 L. J. 432 (Ch. 1885), and many other cases. In re Marshall, 43 Misc. 238, 88 N. Y. Supp. 550 (Sur. Ct. 1904), holds that principal is the original mortgage investment plus any carrying charges advanced from principal.

For a fuller discussion of the cases on these points *see* Notes (1936) 103 A. L. R. 1271, (1937) 115 A. L. R. 881, (1938) A. L. R. 1354; Bailey and Rice, *op. cit. supra* note 1; 2 LEWIN, TRUSTS (Am. ed. 1889), p. 1228.

[14] It is "argued that since the duty to convert the unproductive mortgage arose upon default, the life tenant is entitled to an apportionment upon the basis of an average trust income from that time until the actual sale." (1937) 51 Harv. L. Rev. 175. *See,* Bailey and Rice, *op. cit. supra* note 1, at 327.

[15] Supplied.

[16] In re Nirdlinger's Estate, 327 Pa. 171, 193 Atl. 30, 32 (1937), 2 SCOTT, TRUSTS (1939) Sec. 241.3, at 1370. "Where a loss results from an investment in the mortgage, it seems hard on the remainderman that the life beneficiary should receive income at a greater rate

that the mortgage is security for the payment of both principal and interest. Moreover, the rule of apportionment of unproductive property rests on a duty[17] of the trustee to convert the unproductive trust property into productive property [18] In foreclosing a mortgage, "no question of intent of settlor or mortgagor is involved. In foreclosing the trustee was attempting to get back both interest and principal, and he succeeded only partially in his effort as to each."[19]

What is here called the Canadian Rule was first suggested in the English case *Re Foster*,[20] which was followed by *In re Plumb*.[21] *Re Foster* was "overruled" by *Re Bird*[22] on the ground that there was no precedent for the decision and that under this rule the life tenant might, on final liquidation, receive nothing if he had already received a large amount of income for which he must account. It was further said that if the amount the life tenant had received was sufficiently large the net proceeds would not be sufficient to cover the sum allotted to the remainderman under the calculation. It is true the life tenant will receive nothing at final distribution if he has already received a sufficiently large amount of interest, and the net proceeds are small. But the statement of this result does not prove its injustice. If the life tenant is entitled to nothing in such a situation, he should receive nothing. The question is. To how much is each entitled? Moreover, the fact that the remainderman might be entitled, under the calculation, to more than the net proceeds cannot be a valid objection from his point

than the usual rate of return on trust investments. It is true that he would have received a greater income if there had been no default. But there was a default and interest at the agreed rate was never paid. Why then should the life beneficiary receive interest at that rate? Where the trust estate includes at the outset unproductive land which the trustee is under a duty to sell, the life beneficiary receives out of the proceeds income only at the trust rate. It is believed that the same rule should apply where the property subsequently becomes unproductive." (1937) 4 U. of Pitts. L. Rev 82; (1930) 36 Mich L. Rev 340.

[17] RESTATEMENT, TRUSTS, Sec. 241, subsection 1.

[18] Note (1936) 49 Harv L. Rev 805.

[19] 4 BOGERT on TRUSTS and TRUSTEES (1935) Sec. 820, at 2386.

[20] 45 Ch. Div. 629 (1890).

[21] 27 Ont. Rep. 601 (1896)

[22] (1901) 1 Ch. 916. (The case was one of unauthorized investment not involving a mortgage.) This rule was also overruled in Re Atkinson (1904) 2 Ch. 160, which followed Re Moore, 54 L. J. 432 (Ch. 1885)

of view, since he must receive less under any calculation which would give the life tenant part of the net proceeds.

It remains to consider the merits of the rules.

1. The Two Sums Which Form the Ratio of Apportionment.

In *Re Atkinson*,[23] Cozens Hardy, L. J., said

"I think the true way to approach this question is to treat it as though the whole security had been realized and had produced a certain sum. What would then be the inquiry which the court would have to make? What was due on the security at the time of realization? The answer would be that the capital and the arrears of interest, and no more, were due On what principal are you going to apportion them? Just in the same way as you would if it were a contributory mortgage, part owing to A and part owing to B."

And in *In re Pelcyger's Estate*,[24] it was said.

"In a bond secured by a mortgage, the holder possesses a dual obligation of the mortgagor, namely: (1) for the payment of a specified principal sum at a time or times set forth therein, and (2)[25] a certain rate of interest on such principal sum, payable on stipulated dates. The mortgage property is equally security for both obligations. When the holder is a trustee, the equitable owner of the former obligation is the remainderman, and of the latter, the income beneficiary. When default occurs for a specified period in the payment of interest, both obligations become immediately payable to the trustee and the mortgage property is equally answerable for both."

Suppose the case of a mortgage conditioned on the payment of $1,000 in ten years and $60 interest at the end of each year, with A entitled to the principal and B to the income. A can be entitled to the $1,000 only at the end of ten years, or on default of payment of interest, which would give a right to foreclosure. A's security interest then in the mortgage is the present value of $1,000 payable in ten years if there is no default of the mortgage; or in event of default and foreclosure, the present value of $1,000 payable at that time. B's security interest is the present value of an annuity, of $60 per year for a like period. The New York Rule does not take into account the fact that B's money, the payment of which is secured by the mortgage, is due earlier than that of A. In the case *In re Moore*[26]

[23] (1904) 2 Ch. 160, 169.
[24] 157 Misc. 913, 285 N. Y. Supp. 723, 744 (Sur. Ct. 1936)
[25] Numbers supplied.
[26] 54 L. J. 432 (Ch. 1885).

the life tenant's claim to interest upon the unpaid installments of interest was dismissed on the ground that under the mortgage all that the life tenant could have got was simple interest on the original investment and that there was no fund out of which to pay compound interest. Concededly, there is no fund out of which to pay compound interest, nor is there a fund out of which all the principal and interest payments in arrears can be paid. The problem is rather on what basis shall the insufficient sum be distributed. The Restatement Rule does not take into account the fact that a security transaction is involved.

2. Date of Beginning the Apportionment Period.

In no proper sense can it be said that the land, or the proceeds of the land, still stand as security for that interest that has been paid the life tenant.[27] The New York Court rule recognized this fact by dating the period of apportionment from the first default.[28] The rule announced by the Restatement imposes on the trustee a duty, at the first default, to convert the mortgage into an investment which will earn the prevailing rate on trust investments.[29] The Canadian rule and the submitted rule are based on the view that the beginning of the period fixing the relative interests of the life tenant and remainderman is fixed by the acquisition of the mortgage by the trust estate. Again, take the example of a mortgage for $1,000 payable in ten years, A being entitled to the principal and B to the interest. Clearly, when the mortgage is made, A is secured for the payment of $1,000 in ten years, and B to $60 per year at the end of each of the years. Does the relative security interest of B at the end of each year decrease as that of A increases? This must be answered in the affirmative if it is conceded that B has an absolute right to keep that which he has received, and still demand a share of the net proceeds, no matter how small, in proportion to what is still due him. Otherwise, B has received a part of the total sum for which the mortgage stood security, for which he must account in the final apportionment.

3. Date of Ending the Apportionment Period.

Since the Restatement Rule is founded on the "duty" of

[27] Re Atkinson (1904) 2 Ch. 160, 166.
[28] For variations of this rule see note 14 *supra*.
[29] RESTATEMENT, TRUSTS, Sec. 241, subsection 1, illustration 4.

the trustee to convert the mortgage into productive trust property, it follows logically that the period of apportionment should run until the final realization on the security The New York Rule, as set out in the *Otis*[30] and *Chapal*[31] cases, adopts the same time for the termination of the period. This result has not been reached in all the cases[32] and has been severely criticized.[33] It is clear that there is no longer an obligation to pay interest.[34] If the trustee acts properly in taking the property over[35] the life tenant and the remainderman then become equitable owners of the property in proportion to the amount of their respective equitable claims which they had against the property when it was acquired by the trust estate.[36] Assuming that the trustee is justified in carrying the property in anticipation of an increase in the amount that can ultimately be realized, such a carrying is a joint venture, for the benefit of

[30] Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 80 (1937).

[31] Matter of Chapal's Will, 269 N. Y. 454, 199 N. E. 762 (1936).

[32] See note 14 *supra.*

[33] See note 34 *infra.*

[34] This seems to result from " the indulgence of this fiction, that in spite of the fact that the original investment in the bond and mortgage had ceased to exist, either by its foreclosure, or payment in satisfaction of a deed for the premises, the income beneficiary was still entitled to the interest thereon. The right to receive interest, either legally or equitably, implies the indispensable correlative of a person obliged to pay it, but in the situation under discussion, there is no obligor." In re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723 (Sur. Ct. 1936). " allowance of the mortgage rate throughout, seems especially unsound, since it involves either a guarantee that a mortgage will always earn its full rate until sale, or the imposition of a duty upon the trustee to convert at the first instance of default into a mortgage bearing the same rate as the defaulted investment." Note (1936) 49 Harv. L. 805, at 810.

[35] The purchase of the property by the trustee was not a purchase of real property but " was in effect an act intended only as temporary, in order to prevent immediate loss to the estate." In re Marshall, 43 Misc. 238, 8 N. Y. Supp. 550, 553 (Sur. Ct. 1904). See generally, 2 SCOTT, TRUSTS (1939) Sec. 241.3; Brandeis, *Trust Admr Apportionment of Proceeds of Sale of Unproductive Land and Expenses* (1930) 9 N. C. L. Rev. 127.

[36] In re Pelcyger's Estate, *op. cit. supra* note 24, at 744, the court said: "If, in such a case, the entire security is taken over in satisfaction of the dual obligation, the purchase price of the property thus received consists of the unpaid principal plus the unpaid interest, and thereafter the asset purchased by the extinguishment of the money claims becomes the equitable property of the two persons whose money claims were extinguished by its acquisition, the relative ownerships being in precise proportion to their contributions to the cost of acquisition."

both life tenant and remainderman.[37] If there is an appreciation in the value of the property each will benefit in proportion to his "investment." If the trustee is justified in carrying the property in anticipation of appreciation in value, it is difficult to see under what reasoning income should be allowed to accrue to the life tenant, since the original obligation to pay interest no longer exists,[38] nor is the trustee under a duty to sell the property [39] If during the carrying period a duty to sell the property arises, what does the life tenant lose if the trustee fails to discharge the duty promptly? He loses the use of a sum equal to the value of that portion of the property equitably owned by him, and the income at the current rate on trust investments, on that portion of the property equitably owned by the remainderman. Why should the remainderman restore to the life tenant the loss of the use of the life tenant's equitable part, which loss is not occasioned through any fault or with any profit to the remainderman, but solely through the delay of the trustee? It seems that justice would be done by allowing an apportionment of that part of the property represented by the equity of the remainderman, in accordance with the Restatement rule.

4. Sum to be Apportioned.

Under each of the rules there is one sum to be apportioned, *i. e.,* the net proceeds of the security The New York rule solves the problem by asking simply At the time of the sale what parts of the original claims of life tenant and remainderman were unpaid?[40] The Restatement rule finds a duty to realize on the security at the first default in payments of interest, and as-

[37] In re Pelcyger's Estate, *supra* note 24; In re Tuttle, 49 N. J. Eq. (4 Dick.) 259, 24 Atl. 1, 2 (1892), "If delay be advisable (in realizing the security) it should be held to be a joint venture of the life tenant and the remainderman, *and to that end the income should be allowed to accrue until the delay terminates.*" (Italics ours.) It seems to the writer that since a joint venture was involved, the necessary inference is just the opposite of the one above drawn, that is, that income should not be allowed to accrue to the termination of the delay Hudson County National Bank v. Woodruff, 122 N. J. Eq. 444, 194 Atl. 266, 270 (1937) "The properties having been held for anticipated but unattained appreciation, the delay should be held to be a joint venture between the life tenant and remainderman, because such an investment situation involves the salvage of a security, not for principal alone but for income as well."

[38] See note 34 *supra.*

[39] See note 35 *supra.*

[40] Re Atkinson, *supra* note 23.

sumes, that regardless of the security nature of the transaction, to the life tenant is due the prevailing rate of return on trust investments.[41] The proposed rule and the Canadian rule[42] recognize that no more can be apportioned than the sum in hand. They proceed on the theory that the question concerns the respective interests of the life tenant and the remainderman. The way to determine these is to ascertain what total interests were originally secured by the mortgage, then ascertain what sums, both on intermediate payments and final liquidation, have been realized. The proposed rule gives to each, out of the total sum realized, an amount proportional to his security interest in the mortgage, and each would account for that which he has already received.[43]

II. PURCHASE MONEY MORTGAGE TAKEN BACK ON SALE OF SALVAGED PROPERTY.

Since in some cases the trustee cannot make the most advantageous sale of the salvaged security for all cash, he must accept as part payment a purchase money mortgage on the salvaged property In *Re Nirdlinger's Estate*[44] the view was taken that since the life tenant is ordinarily entitled to receive his share in cash and the remainderman's share is to be reinvested, the purchase money mortgage is to be considered as such investment, and the mortgage should be allotted to corpus and the life tenant should receive all cash. The New York court has taken the view that "both the life tenant and the remainderman should have the responsibility of liquidating the new security, i. e., the purchase-money mortgage",[45] and hence the mortgage should be apportioned to income and corpus in the same proportion as the cash proceeds.[46]

Since the rule applicable to original trust investments does not apply where the trustee is charged with the duty of liquidat-

[41] See notes 15 and 16 *supra;* RESTATEMENT, TRUSTS, Sec. 241, subsection 1, comment (b), illustration 4.

[42] No reasons for the method adopted were given in either Re Foster, *supra* note 20, or In re Plumb, *supra* note 21.

[43] For an illustration of the rules see Appendix, *infra.*

[44] 327 Pa. 171, 193 Atl. 30 (1937). *See also* Bailey and Rice, *op. cit. supra* note 1, at 329.

[45] Re Manger, 165 Misc. 254, 300 N. Y. Supp. 878 (Sur. Ct. 1937)

[46] Re Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937) In re Martin's Estate, 1 N. Y. Supp. (2d) 80, 165 Misc. 597 (Sur. Ct. 1937), Re Chapal's Estate, 292 N. Y. Supp. 663, 161 Misc. 67 (Sur. Ct. 1934).

ing a security the trustee may legally take back a mortgage on the salvaged propery, in which there is greater risk than would be permissible in an original investment.[47] It follows that the mortgage taken back may be one of two types, viz., (a) such a mortgage as would be a legal trust investment if the investment were original or (b) a mortgage which the trustee can take legally only because of the necessity of the salvage situation. It seems that herein is a valid basis of distinction. In situation (a) the salvage operation might well be regarded as at an end, since by allotting all of the purchase money mortgage to corpus, the remaindermen would not be prejudiced, and they should not be heard to complain so long as the principal of the trust is invested in legal trust securities. In situation (b) since the life tenant and remaindermen are engaged in a joint venture in salvaging the security for the benefit of both,[48] the life tenant should not be allowed to shift all of the extraordinary risk to the remaindermen, which risk is in part for the benefit of the life tenant and arises solely from the nature of the transaction. Until the trustee has in his hands cash or a legal trust investment, it is logical to say the salvage transaction is not at an end.[49]

III. EXCHANGE OF DEFAULTED MORTGAGE FOR OTHER SECURITIES.

In *Re Otis*[50] the trustee exchanged one of the mortgages which he held (as part of the trust estate) for Home Owner's Loan Corporation bonds that were subsequently sold for less than the accrued interest and principal due on the mortgage. The New York Court of Appeals regarded the transaction as the exchange of one capital asset for another and held that the general rule that any profit or loss on the sale of a capital asset is

[47] In Re Crimmin's Estate, 288 N. Y. Supp, 552, 159 Misc. 499 (Sur. Ct. 1936).

[48] See notes 36 and 37 *supra.*

[49] See (1937) 51 Harv L. Rev 175. It was intimated in *Re Otis,* 276 N. Y. 101, 11 N. E. (2d) 556, 558 (1937) that the New York court might take this view. After holding the mortgage back should be apportioned between principal and income, the court said: "We do not see how anything else can fairly be done except in a case in which it is conceded that the purchase money mortgage meets the statutory test of a valid new investment."

[50] 276 N. Y. 101, 11 N. E. (2d) 556 (1937).

reaped or borne by principal[51] applied,[52] and hence there should be no apportionment of the net proceeds since he believed the transaction to be essentially a salvage operation and was therefore unable to see any valid distinction between this situation and the one in which the trustee takes over the mortgage property and ultimately sells it at a loss.[53]

"A trustee standing as he does between the life tenant and remaindermen, must not favor one at the expense of the other."[54] In such situations a mortgage is security for the payment of interest to the life tenant, equally as it is security for the payment of the principal to corpus.[55] Therefore, when the trustee exchanged the mortgage for the bonds he extinguished these two security interests and took in lieu thereof the bonds. To hold that the trustee can thus destroy the security interest of the life tenant and give what he has received in exchange therefor to the remainderman, is most clearly to "favor one at the expense of the other." If substance be looked to rather than form, what matter is it that the mortgage is in the one case realized by the sale of the land itself and in the other by the sale of bonds for which the mortgage was exchanged?

In the *Otis* case, the Home Owner's Loan Corporation bonds

[51] II SCOTT, TRUSTS (1939) Sec. 233.1.

[52] "The general situation is different when a trust security other than a mortgage investment goes into default. A market then exists in which bids for the defaulted security are currently quoted. No carrying period is inherent in the process of liquidation in that case. Transfer of such a security by a trustee for a consideration paid in cash (or in cash plus securities lawful for trustees) is the sale or exchange of a capital asset. It is not a salvage operation. The sale proceeds go to the capital account, and any loss of principal is chargeable thereto We think the same practice should be followed where a trustee transfers a defaulted mortgage for cash or for securities which square with the statutory measure of a valid trust investment." Re Will of Otis, *op. cit. supra,* note 51, 11 N. E. (2d) at 558.

[53] "No distinction may be drawn, on the one hand, between the foreclosure and subsequent sale of the real property by the trustee, and, on the other hand, between the substitution of Home Owner's Loan Corporation bonds for the original mortgage and their subsequent sale. Each form of transaction is essentially a salvage operation. The loss suffered by the life tenant in unpaid interest must be given due consideration and restored as far as equitably possible." In Re Otis Estate, 287 N. Y. Supp. 758, 158 Misc. 808 (Sur. 1936) *reversed,* In re Will of Otis, *op. cit. supra,* note 51.

[54] Rhode Island Hospital Trust Co. v. Tucker, 52 R. I. 277, 160 Atl. 465 (1932).

[55] See above text and note 24 *supra.*

were a legal trust investment.[56] A case might arise in which the trustee would be justified in taking securities that did not meet the test of a legal investment.[57] It seems this would offer no great difficulty for in the former case an apportionment in specie could be made at the time of the exchange, or the life tenant's share could be purchased for corpus with other principal. In the latter the trustee could carry the securities until a duty to sell arose, the carrying being regarded as the carrying of foreclosed realty, as a joint venture[58] of the beneficiary and the remainderman.

IV NET PROCEEDS.

Given the gross proceeds from the sale of the salvaged property, how are the net proceeds determined? There is apparently no conflict in the cases on the point that the gross proceeds should be used first to pay foreclosure expenses and the costs of the sale of the property [59] Also, where the trustee acquires the mortgaged property and carries it for some time before final liquidation, as part of the trust estate, the rents collected on the property should be used to pay current carrying charges.[60] However, where the rents are insufficient to meet the carrying charges this unanimity of result completely disappears.[61] There have been holdings, to the effect that such deficit is to be met by sums

1. Advanced from principal, (a) to be repaid as such from rents or the proceeds of the property on final liquidation,[62] (b) to be

[56] In Re Otis, cited *supra* note 51.

[57] Compare with case of purchase money mortgage taken back on sale of salvaged property, note 48 *supra.*

[58] See text above at note 37.

[59] Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937), Re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723 (Sur. Ct. 1936).

[60] Re Phelps' Estate, 162 Misc. 703, 295 N. Y. Supp. 840 (Sur. Ct. 1937), Re Otis Estate, 158 Misc. 804, 287 N. Y. Supp. 758 (Sur. Ct. 1936), Re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723 (Sur. Ct. 1936), Re Nirdlinger, 331 Pa. 135, 200 Atl. 656 (1938)

[61] Re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723 (Sur. Ct. 1936).

[62] Hudson Co. Natl. Bank v Woodruff, 122 N. J. Eq. 444, 194 Atl. 266 (1937), Equitable Trust Co. v. Swobada, 113 N. J. Eq. 399, 167 Atl. 525 (1933), Re Will of Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937) Re Manger's Will, 300 N. Y. Supp. 878, 165 Misc. 254 (Sur. Ct. 1937), Matter of Chapal's Will, 269 N. Y. 464, 199 N. E. 762 (1936), In re Haffin's Will, 280 N. Y. Supp. 357, 155 Misc. 774 (Sur. Ct. 1935), Re Nirdlinger, 331 Pa. 135, 200 Atl. 656 (1938)

added to the capital account in determining the total of the capital investment, as used in fixing the apportionment ratio[63] and, (c) apparently not to be repaid.[64]

2. Advanced from other income of the trust (a) to be repaid from rents or the proceeds on final liquidation[65] and (b) apparently not to be repaid.[66]
3. Borrowed capital from an independent source if there is insufficient capital to make such advancements, although there is other income sufficient to pay the carrying charges.[67]

It seems to be fairly well settled that carrying charges should be advanced from principal, and repaid as such before any apportionment is made.[68] This seems to be a logical and equitable solution, for the life beneficiary is not required to give up other income, and moreover, life tenant and remaindermen each bear a share proportionate to their respective equitable ownership in the property [69]

The further question arises. Should interest be paid on the sum advanced from principal for carrying charges, and paid to the life tenant as income? In *Re Otis*[70] the court, in reversing the decision of the lower court allowing interest to the life tenant, said.

"We think this gives the life tenant too much. The parties are engaged in a joint salvage venture. Carrying charges must be

[63] In re Meyers Estate, 161 N. Y. Supp. 1111 (Sur. Ct. 1916), Matter of Marshall, 43 Misc. 238, 88 N. Y. Supp. 550 (1904).

[64] "What is paid to protect this property is clearly for the benefit of the principal. It is not in any way to produce income as the only object of protecting the property is so that is can be sold for something which will increase the principal of the trust." Matter of Pitney, 113 App. Div. 845, 847, 99 N. Y. Supp. 588, 590 (Sup. Ct. 1906) *See also* Furniss v. Cruikshank, 191 App. Div. 450, 181 N. Y. Supp. 522 (Sup. Ct. 1920) (It does not appear there was an apportionment of the net proceeds in this case.) Matter of Menzie's Estate, 54 Misc. 188, 105 N. Y. Supp. 925 (Sur. Ct. 1907).

[65] In Re Chapal's Will, 280 N. Y. Supp. 811, 245 App. Div. 818 (Sup. Ct. 1935) (*reversed* in Matter of Chapal's Will, 269 N. Y. 464, 192 N. E. 762 (1936)).

[66] Matter of Brooklyn Trust Co., 192 Misc. 674, 157 N. Y. Supp. 547 (Sur. Ct. 1916), *affirmed* 173 App. Div 948, 158 N. Y. Supp. 1109 (Sup. Ct. 1916), *affirmed* 219 N. Y. 565, 114 N. E. 1061 (1916), Meldon v. Delvin, 31 App. Div. 146, 63 N. Y. Supp. 172 (Sup. Ct. 1898), *affirmed* 167 N. Y. 573, 60 N. E. 1116 (1901) (See Re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723, 725, 739 (Sur. Ct. (1936)

[67] Re McKeogh, 158 Misc. 734, 286 N. Y. Supp. 862 (Sur. Ct. 1936).

[68] Hudson Co. Natl. Bank v Woodruff, 122 N. J. Eq. 444, 194 Atl. 266 (1937), Re Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937), Re Nirdlinger, 331 Pa. 135, 200 Atl. 656 (1938)

[69] See Note 36, *supra*, (1937) 36 Mich. L. Rev. 340.

[70] 276 N. Y. 101, 11 N. E. (2d) 556, 557 (1937)

met from principal because there is no income wherewith to pay them. Interest on each item would have to be computed at the currently prevailing rate for legal investments, a fluctuating factor not always readily obtainable. The parties can hardly be thought to have contemplated such actuarial calculations. In view of all this and of the fact that the remaindermen run by far the greater hazard, we think the life tenant must be supposed to have said to them, 'You put up all the money for the salvage and I won't expect any interest on it.' "[71]

The other view, and seemingly the sound one, is well stated in *Re Pelcyger's Estate*.[72]

" The court believes that invidious distinction should not be made depending on whether or not the trust estate had free capital available to pay the costs of foreclosure. If it did not and borrowing from an outside source were necessary, capital so procured would receive an interest return which would be properly chargeable as an additional salvage expense. If the same method were not adopted where the trust capital is used, then income beneficiary would be deprived of a part of his gift, namely, the use of so much of the capital as is thus employed for the partial benefit of the remainderman. It follows that the average daily capital employed in the salvage operation should be computed and a reasonable return allowed thereon as an added salvage cost. Since the security for such advances would usually be excellent,[73] the return should approximate the current legal investment rate for the period. "[74]

V RENTS.

In case the rents collected on the property while it is being carried by the trustee after foreclosure of the mortgage, exceed the carrying charges, what is the proper disposition of such surplus? In the Pennsylvania case of *Re Nirdlinger*[75] the following solutions were proposed

"(1) That the net rents shall be held by the trustee until the properties are sold, when the formula[76] fixed by us shall be applied;[77]

[71] *Accord:* In re Wilson's Estate, 167 Misc. 754, 4 N. Y. Supp. (2d) 634 (Sur. Ct. 1938), In re Manger's Will, 165 Misc. 254, 300 N. Y. Supp. 878 (Sur. Ct. 1937), In re Chapal's Estate, 161 Misc. 69, 292 N. Y. Supp. 663 (Sur. Ct. 1934).

[72] 157 Misc. 913, 285 N. Y. Supp. 723, 752 (Sur. Ct. 1936).

[73] The advances constitute a prior claim on both the income from the property and the proceeds on final liquidation. *See* cases cited, note 55 *supra.*

[74] *Accord:* Re Nirdlinger's Estate, 327 Pa. 171, 193 Atl. 30 (1937); In re Otis' Estate, 158 Misc. 804, 287 N. Y. Supp. 758 (Sur. Ct. 1936) (*reversed* by In re Otis, *op. cit.* note 62 *supra.*)

[75] 331 Pa. 135, 200 Atl. 656 (1938)

[76] The court apparently means the Restatement Rule of Apportionment of net proceeds.

[77] In re Otis' Estate, 158 Misc. 804, 287 N. Y. Supp. 758 (Sur. Ct. 1936) (See modification of this holding made in Re Otis, *op. cit.* note 79 *infra*), See also Hubbard v. Safe Deposit and Trust Co. of Baltimore, 172 Md. 645, 192 Atl. 592 (1937).

"(2) That the trustee may pay over the rents or a portion thereof to the life tenants in the trustee's discretion;[78]

"(3) That all the net rents shall be paid over to the life tenants, (a) with a liability to refund to the corpus of the trust any amount received in excess of that which the formula gives; (b) without requirement to refund anything."[79]

The Pennsylvania court believed "the real intent of testators is that life tenants shall presently receive accruing income";[80] further if trustees were given discretion whether to pay the income over, they would in most instances (to avoid any chance of liability) retain the net rents until final distribution. The court held that the trustees must pay the rents over to the life tenants as they accumulate, and that the life tenants would be under an obligation to refund "where they have received more than would be due them under the formula."[81]

It is true the testator intended the life tenant to have the accruing income. It is equally true that he did not intend the life tenant to have any part of the sum which should constitute corpus, otherwise the trust would not have been created. Hence it would seem that the payment to the life beneficiary of *all* of the net rents, when ultimately he may have to make some repayment to the corpus, is unjustified.

To give the trustee discretion when and what amounts he should pay to the life tenant, is open to the same criticism and in addition it is objectionable on the reasoning advanced in *Re Nirdlinger*.[82] Under the New York rule[83] of apportionment any payment of rents to the life tenant without a proportionate payment to corpus is inconsistent with the theory that the foreclosed property is equitably owned by the life tenant and the remaindermen (in proportion to their respective claims which were satisfied when the property was acquired by the trust estate).[84] This is true since under that rule the ratio of

[78] Re Otis, 276 N. Y. 101, 11 N. E. (2d) 556 (1937) In re Manger's Will, 165 Misc. 254, 300 N. Y. Supp. 78 (Sur. Ct. 1937), In re Phelps' Estate, 162 Misc. 703, 295 N. Y. Supp. 840 (1937), Re Chapal, 269 N. Y. 464, 199 N. E. 762 (1936).

[79] In re Horn's Estate (1924) 2 Ch. 222 (However, there was a statute which the court construed to place the property obtained on foreclosure of a mortgage in so far as possible as if it had originally formed part of the testator's estate).

[80] Re Nirdlinger, 331 Pa. 135, 200 Atl. 656, 657 (1938).

[81] *Ibid,* 200 Atl. 656, at 657.

[82] See text above at note 81.

[83] See text above, also cases cited note 6, *supra.*

[84] See text above, also notes 36 and 37, *supra.*

apportionment is fixed by the respective claims of life tenant and remainderman as of the time of *final liquidation.* Therefore, to the extent that the life tenant's claim is reduced by receiving net rents, without a proportionate payment being made to corpus, the ratio of the life tenant's share of the net proceeds will be diminished, and hence his share of the ultimate loss on the security

The view that the trustee should in all instances allow the rents to accumulate until final distribution of the net proceeds would deny to both life tenant and remainderman the beneficial use of the funds lying idle.

If it is correct that on the acquisition of the mortgaged property by the trustee, the life tenant and the remainderman become equitable owners of the property so acquired, then the payment of all the rents to the life tenant without any liability on his part to refund any overpayment, seems clearly wrong. Equity should be done the life tenant. But to be equitable does not mean to be charitable. What justification is there for taking that which is the remainderman's and giving it to the life tenant?[85]

It is submitted that the trustee should have discretion, to be exercised in view of the needs of the life tenant and the trust estate,[86] whether to retain the net rents or pay them over, and if all or any part of the rents is paid over, to each (life tenant and remainderman) should go a share proportionate to his equitable ownership of the property.[87] This would be a simple matter under the submitted rule of apportionment.[88] Under this rule the ratio in which each is to share in the net proceeds is fixed on the termination of the security by the foreclosure and sale, and

[85] The court, in Re Pelcyger's Estate, 157 Misc. 913, 285 N. Y. Supp. 723, at 746 (Sur. Ct. 1936) in discussing whether or not the life tenant should be allowed interest after the foreclosure of the property said, " the primary principle elsewhere universally applied is that there shall never be any entrenching upon the rights of the remaindermen except where a corresponding benefit is demonstrated."

[86] "This discretion, moreover, should be exercised with appropriate regard for the fact that unless a life tenant gets cash he does not get anything in the here and now." Re Otis, 276 N. Y. 101, 11 N. E. (2d) 556, 559 (1937).

[87] This view was adopted in Re Acketill, (1891), Ir. L. R. 27 Eq. 331.

[88] See text above, page 2.

does not subsequently change. Under the New York and the Restatement rules, an approximation subject to final adjustment would have to be made, since the proportion in which the life tenant and remaindermen share in the net proceeds cannot be finally determined until the date of final liquidation.

Under this method the life tenant would receive all he could justly ask. (a) a share of the net rents proportionate to his equitable ownership of the property (if and when the trustee was under a duty to pay them over) and (b) the share to which the remainderman was entitled would be invested as a part of the corpus of the trust, on the whole of which the life tenant would be entitled to income.[89]

SUMMARY.

A mortgage carried as part of a trust estate, established for the benefit of life tenants and remainderman, is security for the payment of two sums, (a) the annual interest payments to the life tenant, and (b) the principal to the corpus. If it becomes necessary for the trustee to acquire the mortgaged property through foreclosure or some other means and if the intention of the testator cannot be ascertained, the net proceeds of the salvaged property must be apportioned between life tenants and remainderman according to some rule of law which will give each a share proportionate to his equity in the mortgage.

Under the New York rule the life tenant and remainderman share in the net proceeds in proportion to their respective claims against the mortgaged property as of the time of final liquidation of the security Since this rule allows interest to accrue during the time the trustee carries the property, it disregards the fact that foreclosure of the mortgage terminated the obligation of the mortgagor to pay interest.

The Restatement rule is the same as that for the apportionment of the proceeds of unproductive land which the trustee carries after he is under a duty to convert it into productive trust assets, viz. the remainderman is given that part of the net proceeds which if invested when the first default in interest

[89] It should be noted that income on that part of a purchase money mortgage taken back by the trustee on sale of the salvaged property, and allotted to corpus is true income. See In re Martin's Estate, 65 Misc. 597, 1 N. Y. Supp. (2d) 80 (Sur. Ct. 1937)

occurred, would with interest at the current rate on trust investments equal the net proceeds at the time of final realization. The security nature of the transaction is disregarded under this rule. Moreover, the rule of apportionment applicable to unproductive land is founded on the duty of the trustee to convert, a factor that is not present in the mortgage situation.

Neither of the above rules takes into account the fact that the life tenant may have already received a greater proportion of his original security interest in the mortgage than the remainderman would receive if he took the whole of the net proceeds.

By the Canadian Rule, life tenant and remainderman must bring into hotch pot to add to the net proceeds that which they have already received toward the satisfaction of their respective security interests and each is awarded a share in the total thus obtained in proportion to what each would have received had there been no default. This rule does not take into account the fact that the life tenant's right to interest may be cut off by default and foreclosure. Neither of the above three rules gives any consideration to the fact that payment of the sums secured to the life tenant were due at an earlier date than payment of principal.

Under the rule suggested in this paper, life tenant and remaindermen must bring into hotch pot and add to the net proceeds that which they have already received toward the satisfaction of their respective security interests. Each then shares in the total thus obtained in proportion to his respective original security interests in the property (The security interest of the remainderman is calculated by finding the present value of the principal of the mortgage due in the number of years from the acquisition of the mortgage by the trust estate to the maturity of the mortgage, or its foreclosure, whichever period is shorter. The security interest of the life tenant is found by ascertaining the present value of an annuity of the amount of the annual interest payments for a like number of years.)

It seems to the writer that this rule is open to none of the objections advanced to the first three rules. It does not allow interest to accrue after the obligation to pay is terminated. Nor is it founded on a fictitious duty of the trustee to convert the

mortgage into productive assets. It takes into account that which has already been received by each and the fact that the sums secured to the life tenant are due sooner than those secured to the remainderman.

Where a purchase money mortgage is taken back by the trustee on a sale of property he has acquired by foreclosure, if the mortgage meets the test of a legal trust investment, the salvage operation may well be regarded as at an end, the mortgage apportioned to corpus, and the life tenant given all cash. If there is extraordinary risk in the mortgage the life tenant should help liquidate the new security, hence the mortgage should be apportioned in the same proportion as the cash.

It has been held that an exchange by the trustee of a defaulted mortgage for other legal trust securities, constituted the exchange of one capital asset for another and that there should be no apportionment of the net proceeds of the sale of such security On principal, it seems that this amounted to taking that which was the life tenant's and giving it to the remainderman, for the security interest of the life tenant was terminated and that which was received in exchange appropriated to corpus.

If rents on the salvaged property which is being carried by the trustee are not sufficient to pay current carrying charges, the deficit should be advanced from principal, to be repaid in full from net proceeds before any apportionment is made. Although the cases are in conflict, the sounder view seems to be that the life tenant should be allowed interest to be paid from the net proceeds on the capital sums thus advanced. If such interest is not allowed the life tenant will be deprived of part of his gift—i. e.) the right to the income on the whole of the corpus.

In cases where the net rents exceed the carrying charges, the decisions are conflicting as to whether or not, and under what circumstances the surplus should be paid over to the life tenant. In view of the fact that the trustee is engaged in a salvage operation, for the joint benefit of remainderman and life tenant, it seems that each is entitled to a share of the net rents in proportion to his equitable ownership of the property Also, it

would seem wise to give the trustee discretion as to when and in what amounts to distribute. This discretion should be exercised in consideration of the present needs of the life tenant, and the probable future expenses in carrying the property

APPENDIX

Illustrations of the Rules

The rules may be illustrated by the following hypothetical cases

1. The trust estate acquires a mortgage conditioned on the payment of $1,000 at the end of 10 years, and $60 interest at the end of each year. If there were default in any interest payment, the trustee might foreclose immediately to realize both accrued interest and principal. No interest payments were made. The trustee, not violating his duty, foreclosed at the end of the tenth year and realized from the property, $1,790.85.[1]

2. Same facts as (1) except, the first six annual interest payments were made; the trustee foreclosed at the end of the tenth year realizing $1,000 from the property

3. Same facts as (2) except, the trustee realizes only $500 on the sale of the property

4. Same facts as (1) except, the trustee acquired the mortgaged property at the end of the tenth year and carried it for fifteen years, realizing therefor, $1,000.

5. Same facts as (4) except at the end of the fifth year the trustee was under a duty to sell the property so carried.

The results reached by applying the four rules to the above situations are set forth in the following table

[1] This figure was obtained by adding to the principal of the mortgage the *amount* of an annuity of $60, at six per cent for ten years. *See* Hart, the Mathematics of Investment, Table VII, p. 52, col. 6.

APPORTIONMENT BETWEEN LIFE TENANT AND REMAINDERMAN OF LOSS ON DEFAULTED MORTGAGE[2]

Hypo Case	Amounts Allotted Under the Rules							
	New York Rule		Restatement Rule*		Canadian Rule		Proposed Rule	
	Life Tenant	Remainderman	Life Tenant	Remainderman	Life Tenant	Remainderman	Life Tenant	Remainderman
1	$671 57	$1,119 28	$511 67	$1,279 18	$671 57	$1,119 28	$790 85	$1,000 00
2	193 55	806 45	137 93	862 07	150 00	850 00	240 59	759 41
3	96 77	403 23	68 97	431 03	00	500 00	19 78	480 22
4	532 71	467 29	431 82	568 18			240 59	759 41
5	532 71	467 29	431 82	568 18			457 56	542 44

* The calculation under this rule was made at four per cent interest

[2] Under the New York rule, where r is the mortgage rate of interest, t, the time from default to the final realization on the prop-

erty, P, the principal of the mortgage, and n the net proceeds, the life tenant's share would be found by the formula:

$$\text{Life Tenant's Share} = \frac{r\ t\ P}{r\ t\ P\ +\ P} \times n$$

$$\text{i. g. L. T. S.} = \frac{600}{1600} \times 1{,}790.85 = 671.57$$

Under the Restatement rule with r the prevailing rate on trust investments, the formula is the same. i. g.

$$\text{L. T. S.} = \frac{.04 \times 6 \times 1000}{.04 \times 6 \times 1000 + 1000} \times 1000 = 511.67$$

Under the Canadian rule where r is the mortgage rate, t the time from acquisition of the security by the trust estate until the mortgage is due, P the principal, N the net proceeds, and R the payments the life tenant has received, the life tenant's share is found by the formula:

$$\text{L. T. S.} = \frac{r\ t\ P}{r\ t\ P\ +\ P} \times (N + R) - R$$

Under the submitted rule where P is the principal, I the annual interest payment (rP as under the New York rule), x the present value of an annuity of \$1 for the number of years from the acquisition of the mortgage by the trust estate, until the maturity of the mortgage or foreclosure and sale, taking whichever period is shorter; y, the present value of \$1 due in a like period, R the interest payments that have been received by the life tenant; N the net proceeds; the life tenant's share is found by the formula:

$$\text{L. T. S.} = \frac{Ix}{Py\ +\ Ix} \times (N + R) - R. \quad i.\ g. \text{ in Case 1}$$

$x = 7.3601$ (see Hart, *op. cit. supra* note 43, Table VIII, p. 62)
$I = 60.$
$y = .5584$ (Hart, *op. cit. supra,* Table VI, p. 42)
$N = 1790.85.$
$R = 0$
$P = 1{,}000.$

$$\text{L. T. S.} = \frac{7.3601 \times 60}{(7.360 \times 60) + (.5584 \times 1000)} \times (N + 0) - 0 = 790.85$$

Since \$1 equals the present value of \$1 due in x years, plus the present value of an annuity of the annual interest payments due on \$1 for x years,

$$\text{L. T. S.} = \frac{IX}{Py + Ix} \times (\text{N} + \text{R}) - \text{R} = \frac{\text{Ix}}{\text{P}} \times (\text{N} + \text{R}) - \text{R}.$$

Under case 5 by applying the above formula L. T. S.= \$240.59; remainderman's share = \$759.41 (that is, \$1,000 — \$240.59). By applying the Restatement rule on that portion of the carrying period from the time the duty to sell arose, to the final realization on the security (ten years), the life tenant is entitled to a further sum of \$216.97, making a total of \$457.56.

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